



April 24, 2001

**MEMORANDUM TO:** Board of Directors

**FROM:** Arthur J. Murton, Director  
Division of Insurance

**SUBJECT:** BIF Assessment Rates for the Second  
Semiannual Assessment Period of 2001

**Recommendation**

The staff recommends that the Board maintain the existing Bank Insurance Fund (BIF) assessment rate schedule of 0 to 27 basis points (bp) per year. This rate schedule complies with the statutory requirements for the Board to establish a risk-based assessment system and set assessments only to the extent necessary to maintain the target Designated Reserve Ratio (DRR), currently 1.25 percent.

**Summary**

The Federal Deposit Insurance Act (FDI Act) governs the authority of the Board to set BIF assessment rates and directs the Board to establish a risk-based assessment system for insured depository institutions and set assessments to the extent necessary to maintain the reserve ratio at 1.25 percent. The reserve ratio for the BIF stood at 1.35 percent (unaudited) as of December 31, 2000, and it is likely that the reserve ratio will remain above 1.25 percent through the end of 2001 unless insurance losses or deposit growth depart significantly from recent experience. Thus, it does not appear that additional assessment revenue will be needed to maintain the target DRR through the second semiannual period of 2001, and the staff consequently recommends no changes to the rate schedule.

Some institutions will pay premiums under this schedule even though the reserve ratio exceeds the target DRR; however, the view of the staff is that the current schedule is consistent with the statutory requirement to establish a risk-based assessment system. Based upon year-end 2000 data and projected ranges for the relevant variables as of December 31, 2001, this rate schedule would result in an average annual assessment rate of approximately 0.13 bp.

## **ANALYSIS**

In setting assessment rates since recapitalization of the BIF, the Board has considered: (1) the balance between revenues and expenditures over time, (2) the statutory requirement to maintain the DRR, currently 1.25 percent, and (3) all other relevant statutory provisions.<sup>1</sup>

### **Long-Run Considerations**

Based on a thorough review of FDIC experience and consideration of statutory changes designed to moderate future deposit insurance losses (e.g., prompt corrective action authority, national depositor preference and the least-cost resolution requirement), analysis conducted by FDIC staff at the time of the BIF recapitalization concluded that an effective average assessment rate of 4 to 5 bp annually would be appropriate to achieve long-run balance between BIF revenues and expenses (where expenses include monies needed to prevent dilution due to deposit growth). Thus, in 1995, the "base" rate schedule for the BIF was established at 4 to 31 bp annually. Given conditions of slow to moderate deposit growth and minimal insurance losses, which reduced the need for assessment revenue, the Board shifted the effective annual

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<sup>1</sup> The Board is required to review and weigh the following factors when establishing an assessment schedule: a) the probability and likely amount of loss to the fund posed by individual institutions; b) case resolution expenditures and income; c) expected operating expenses; d) the revenue needs of the fund; e) the effect of assessments on the earnings and capital of fund members; and f) any other factors that the Board may deem appropriate. These factors directly affect the reserve ratio prospectively and thus are considered as elements of the requirement to set rates to maintain the reserve ratio at the target DRR.

rate schedule downward to 0 to 27 bp as of 1996.<sup>2</sup> The Board did not alter the base rate schedule, which remains today at 4 to 31 bp. In recommending that the Board maintain the base schedule at 4 to 31 bp, the staff previously expressed the view that a rising BIF reserve ratio was not necessarily indicative of a long-run trend, given the historical volatility of deposit growth and insurance losses. Recent events support this view and demonstrate the volatility of the reserve ratio.

### **Maintaining the Target DRR Over the Next Assessment Period**

The BIF reserve ratio stood at 1.35 percent as of December 31, 2000 (unaudited), the latest date for which complete data are available. In view of the current and projected levels of the BIF reserve ratio, the current rate schedule appears to be consistent with the statutory requirement to maintain the target DRR of 1.25 percent.

The financial institutions industry could face increasing challenges over the coming months due to signs of slower economic growth, reduced corporate profits, and reduced consumer confidence. The significance of any financial problems that may develop at insured institutions is largely dependent on the duration and depth of the current economic slowdown. Concerns over slowing economic conditions are tempered by the overall strength of the industry, which by most measures is much stronger than it was going into the economic recession of 1990 to 1991.

With the slowing economy as a backdrop, the FDIC continues to monitor a number of areas that pose risks to BIF-insured institutions. Foremost among these is commercial credit quality, which continues to decline based on an increasing rate of net loan losses, rising

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<sup>2</sup> The FDIC may alter the existing rate structure and may change the base BIF rates (currently 4 to 31 bp) by rulemaking with notice and comment. Without a notice-and-comment rulemaking, the Board has authority to increase or decrease the effective rate schedule uniformly up to a maximum of 5 bp, as deemed necessary to maintain the target DRR.

nonperforming loan levels, increased loan loss provision expenses related to deteriorating commercial portfolios, and the rise in adversely classified Shared National Credits (SNCs). Risk selection practices evident in a number of institutions over the past several years also raise concerns. Loan portfolios that pose the greatest degree of concern in light of a slowing economy include subprime consumer loans, high loan-to-value mortgage loans, and loans to highly leveraged businesses. Also noteworthy has been the growth in lending concentrations for a number of institutions in areas historically associated with higher loan loss rates including construction financing, commercial real estate lending, and commercial lending. In addition, the FDIC continues to monitor the growing reliance on non-deposit funding sources, which has contributed to an ongoing decline in net interest margins (NIMs) and in some cases an increasing sensitivity to rising interest rates. The recent decline in short-term interest rates prompted by easing Federal Reserve monetary policy could alleviate the pressure on NIMs for many institutions. However, a general decline in interest rates could also spur a significant growth in mortgage refinancing activity, which could lead to greater sensitivity to rising interest rates to the extent institutions generate a large volume of fixed rate loans for their own portfolios. For some of the largest institutions, the level of reliance on market-related fee income and venture capital earnings is a concern due to recent market declines and prospects for declining capital markets activity.

Taking appropriate steps to address these concerns continues to be a priority for the FDIC. The staff is addressing these risks through various means, including the enhancements to the risk-based premium system (RBPS) that became effective with the first semiannual assessment period of 2000. The enhancements are intended to provide a more flexible, forward-looking system that keeps pace with new and emerging risks. Call Report information is used to identify institutions with atypical risk characteristics among those in the best-rated premium category, and a review is conducted to determine whether there are unresolved concerns

regarding risk management practices. Where such concerns are present, the institutions are given an opportunity to address the cited deficiencies with risk management practices before higher premiums are assessed.

During the last assessment cycle, 162 BIF-insured institutions were flagged by the new Call Report screens, and four institutions were notified that they would be candidates for reclassification. It has not yet been determined whether the four institutions have adequately addressed our risk-management concerns. In this cycle, the screens identified 165 BIF-insured institutions for review, and the list of institutions was distributed to the other banking agencies in mid-April. After a review period that will end in May, the agencies will meet to decide on the candidates for notification.

Because the financial condition of the industry is so strong, the current concerns regarding a rising level of risk exposure are not expected to generate a large increase in failures or BIF insurance losses over the near term. With regard to maintaining the target DRR through the next assessment cycle, the staff's judgment is that the current assessment rate schedule is appropriate. Following is an analysis of the anticipated effect of changes in the fund balance and the rate of insured deposit growth on the reserve ratio through December 31, 2001.

## **1. Fund Balance**

The BIF unaudited balance was \$30.975 billion on December 31, 2000. For a given assessment rate schedule, changes in the balance over the short run are determined largely by changes in insurance losses and interest income, and unrealized gains and losses on available-for-sale (AFS) securities.

**Insurance Losses.** Insurance losses consist of two components: a contingent liability for future failures and an allowance for losses on institutions that have already failed. Potential changes in contingent liabilities for the twelve months ending December 31, 2001, reflect the

range of year-end 2000 estimates from the Financial Risk Committee (FRC) plus any adjustments for: (1) potential losses on failures that have occurred since December 31, 2000; and (2) potential failures identified subsequent to the FRC's estimates. The resulting range for changes in contingent liabilities is \$100 million to \$600 million.

Table 1 projects low and high estimates for the provision for losses based on the changes in contingent liabilities and an adjustment for the net recovery value of closed banks in receivership as of December 31, 2000.

**Table 1**  
**Potential Changes in Contingent Liabilities and Allowance for Losses <sup>(1)</sup>**  
**December 31, 2000 to December 31, 2001**

	<b>Low Loss Estimate</b>	<b>High Loss Estimate</b>
Contingent Liability for Future Losses	\$100 million	\$600 million
Allowance for Losses: Closed Banks (2)	(\$20 million)	\$20 million
<b>Total Provision for Losses</b>	<b>\$80 million</b>	<b>\$620 million</b>

*Notes:*

- (1) Both projections reflect the information available as of March 31, 2001, regarding future economic conditions.
- (2) Assumes a range of approximately -5 percent to +5 percent of the estimated net recovery value of bank resolutions, \$350 million as of December 31, 2000 (rounded to the nearest \$5 million).

**Interest Income and Unrealized Gains and Losses on AFS Securities.** The average BIF investment portfolio for the twelve months ending December 31, 2001, is estimated to be approximately \$30.5 billion. Based on the possibility of a shift in the level of interest rates of plus or minus 100 bp for new investments, interest income is projected to be between \$1.875 billion and \$1.919 billion for the twelve months ending December 31, 2001. Because of the significant percentage of AFS securities held in the insurance fund portfolio at this time, when interest rates change, the magnitude of the change in market value of the securities dominates the effect of changes in interest income. Therefore, in Table 2 on the next page, the higher interest rate scenario drives the low projected fund balance.

Table 2 summarizes the effects on the fund balance of the low and high estimates that define the ranges assumed for interest income, unrealized gains and losses on AFS securities, and insurance losses.

**Table 2**  
**Projected Fund Balance** <sup>(1)</sup>  
(\$ in millions)

	<b>Low Projected Balance</b>	<b>High Projected Balance</b>
Assessments (2)	43	43
Interest Income (3)	1,919	1,875
<b>Total Revenue</b>	<b>1,962</b>	<b>1,918</b>
Operating Expenses	800	800
Provision for Losses	620	80
<b>Total Expenses &amp; Losses</b>	<b>1,420</b>	<b>880</b>
<b>Net Income</b>	<b>542</b>	<b>1,038</b>
Unrealized Gain (Loss) on AFS Securities (3)	(91)	377
<b>Comprehensive Income (Loss) (4)</b>	<b>451</b>	<b>1,415</b>
Fund Balance (Unaudited) – 12/31/00	30,975	30,975
<b>Projected Fund Balance – 12/31/01</b>	<b>31,426</b>	<b>32,390</b>

*Notes:*

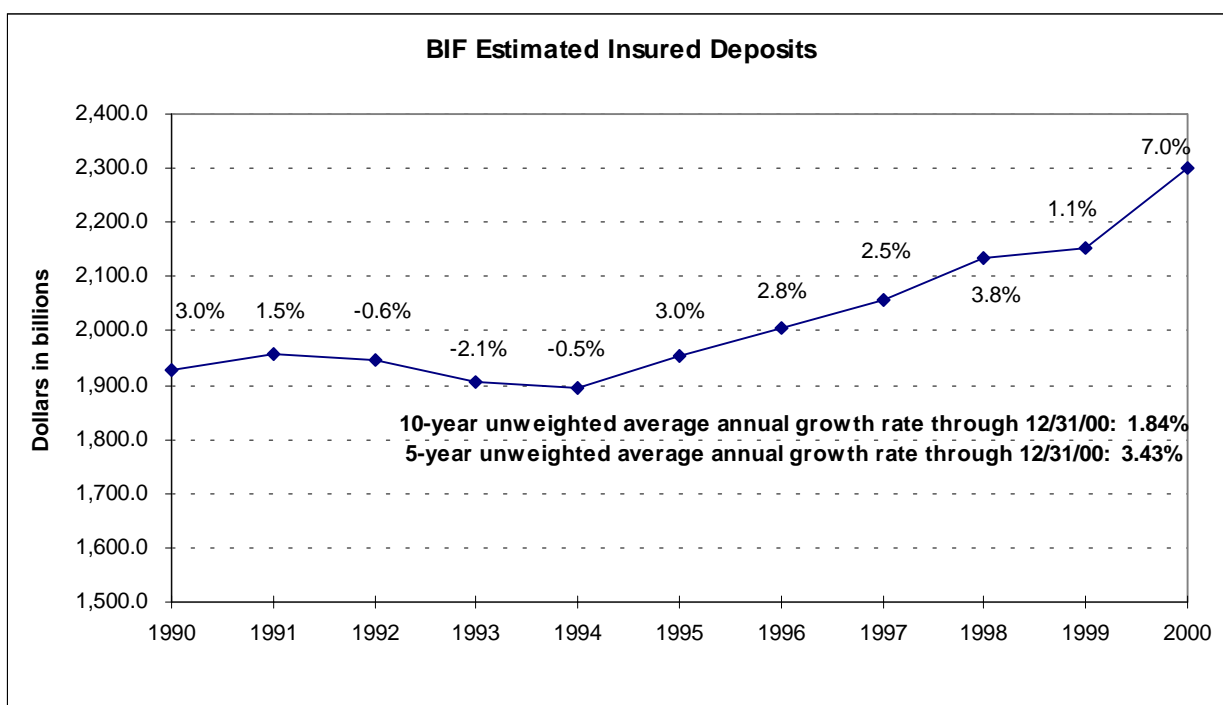
- (1) Projected income and expense figures are for the twelve months from December 31, 2000, through December 31, 2001.
- (2) Assumes that the current assessment rate schedule remains in effect through December 31, 2001.
- (3) Portfolio yield is estimated to be between 6.14 percent (high projected balance) and 6.28 percent (low projected balance), reflecting a shift in the level of interest rates of + or – 100 bp from the level of interest rates as of the beginning of March 2001. Note: Because of the significant percentage of AFS securities held, the magnitude of the change in market value of these securities offsets the interest income changes. In the table, compare Interest Income with Unrealized Gain (Loss) on AFS Securities. The average invested fund balance is estimated to be approximately \$30.5 billion. Unrealized Gain (Loss) on AFS securities includes \$139 million in gains for the year-to-date ending February 28, 2001.
- (4) Comprehensive Income is used instead of Net Income due to the magnitude of the change in market value of AFS securities that occurs with fluctuations in interest rates. See note (3).

## 2. Insured Deposits

Since 1990, annual growth of BIF-insured deposits has been as high as 7.0 percent and as low as an annual shrinkage of 2.1 percent (see Figure 1, next page). After shrinking annually from 1991 through 1994, insured deposits grew between 2.5 percent and 4.0 percent from 1995 to 1998. After minimal growth in 1999 (1.1 percent), insured deposits grew by a rapid 7.0 percent in 2000. This was the highest annual growth rate since 1989.

The growth in insured deposits in 2000 was spurred by an 81 percent increase in insured brokered deposits. About half of that amount (almost 25 percent of total growth for the year) was attributable to the use of sweep cash management accounts whereby uninvested balances are swept into FDIC-insured deposits. Stock market volatility and a favorable interest rate environment (making CDs a more popular investment option) also contributed to the strong deposit growth.

**Figure 1**



Although the Federal Reserve began lowering benchmark interest rates in the first quarter of 2001, which could make CDs and other interest-bearing deposit accounts less attractive this year, continued stock market volatility in the first quarter suggests that deposits may remain an attractive investment in the near future. In addition, potential reductions in federal debt levels could make short-term U.S. Treasury securities less prevalent, so that investors turn to alternatives such as insured deposits.

It takes approximately \$17 billion in estimated insured deposit growth to create a 1 basis point change in the BIF reserve ratio, all other things held constant. With the reserve ratio currently at 1.35 percent, it would therefore take about \$170 billion in insured deposit growth to reduce the fund to the Designated Reserve Ratio level, all else being equal. \$170 billion is about 7 percent of estimated insured deposits as of December 31, 2000. It is unlikely that deposit growth alone would drive the reserve ratio below 1.25 percent any time soon. Comprehensive income for the BIF in 2000 was over \$1.5 billion. Only if insurance losses rise significantly in combination with rapid deposit growth would the reserve ratio fall below its target in the near term.

According to information gathered by the FDIC, in addition to those investment firms with sweep programs in progress, there are other large brokerage/mutual fund companies with uninsured money market balances totaling in excess of \$180 billion. These companies have not announced any plans to sweep these balances into insured accounts, but this cannot be ruled out. Virtually all of the largest banks in the system have an investment company affiliate.

Considering the experience of the last five years and current market conditions, the best judgment of the staff is that BIF-insured deposits are likely to experience a growth rate in the range of +2 percent to +7 percent between December 2000 and December 2001. The high end of this range reflects the possibility that deposits will remain attractive to investors over the period due to stock market volatility as well as the potential for increased transfers of sweep cash management accounts into BIF-insured deposits.

### **3. BIF Reserve Ratio**

Based on the projected BIF balance and the growth of the insured-deposit base, the staff projects the BIF reserve ratio to be within the range of 1.28 percent to 1.38 percent at December 31, 2001 (Table 3, next page). The low estimate, which produces a 7 bp decrease

from the December 31, 2000 ratio, reflects an assumed stronger increase in the insured deposit base (+7 percent) and a downward adjustment to the fund balance for unrealized losses on AFS securities (see Table 2). The low estimate also reflects the highest losses from possible near-term failures as projected by staff; the estimate is not intended to represent a "worst-case" scenario. The high estimate produces an increase of 3 bp above the December 31, 2000 level, and reflects +2 percent growth in the BIF-insured deposit base and a stronger increase in the BIF balance due to lower insurance losses and an adjustment for unrealized gains on AFS securities.

**Table 3**  
**Projected BIF Reserve Ratios**  
(\$ in millions)

<b>December 31, 2000</b>		
Fund Balance (Unaudited)	\$30,975	
Estimated Insured Deposits	\$2,301,604	
BIF Ratio	1.35%	
	<b>Low Estimate (1)</b> <b>December 31, 2001</b>	<b>High Estimate (2)</b> <b>December 31, 2001</b>
Projected Fund Balance	\$31,426	\$32,390
Estimated Insured Deposits	\$2,462,716	\$2,347,636
Estimated BIF Ratio	1.28%	1.38%

*Notes:*

- (1) The low estimate refers to the scenario of higher interest rates (portfolio yield: 6.28 percent, because of unrealized losses on AFS securities-see note 3 in Table 2), a higher provision for losses (\$620 million) and a higher insured deposit growth rate (+7 percent).
- (2) The high estimate refers to the scenario of lower interest rates (portfolio yield: 6.14 percent, because of unrealized gains on AFS securities-see note 3, Table 2), a lower provision for losses (\$80 million) and a lower insured deposit growth rate (+2 percent).

As indicated in Table 3, even if the low estimate were to be realized, the current rate schedule would be sufficient to maintain the DRR through December 31, 2001. Recent events, however, have underscored the potential for unanticipated insurance losses. Note that under the pessimistic scenario, the BIF could sustain additional insurance losses of approximately \$650 million without falling below the DRR as of December 31, 2001.

**Risk-based assessment system.** The staff recommends retaining the current spread of 27 bp between the highest- and lowest-rated institutions as well as the rate spreads between adjacent cells in the assessment rate matrix. The proposed assessment rate schedule, ranging from 0 to 27 bp per year, appears in Table 4. The Board previously determined that the current rate spreads provide appropriate incentives for weaker institutions to improve their condition and for all institutions to avoid excessive risk-taking, consistent with the goals of risk-based assessments. The current rate spreads also generally are consistent with the historical variation in bank failure rates across cells of the assessment rate matrix.

In setting assessment rates to achieve and maintain the reserve ratio at the target DRR, the Board is required to consider the effects of assessments on members' earnings and capital. The estimated annual revenue from the existing rate schedule is \$43 million, the same as in the previous period. In recommending that the Board maintain this schedule, the staff has considered the impact on earnings and capital and found no unwarranted adverse effects.

**Table 4**  
**Proposed Assessment Rate Schedule**  
**Second Semiannual Assessment Period of 2001**  
**BIF-Insured Institutions**

<b>Capital Group</b>	<b>A</b>	<b>B</b>	<b>C</b>
<b>1. Well</b>	<b>0 bp</b>	<b>3 bp</b>	<b>17 bp</b>
<b>2. Adequate</b>	<b>3 bp</b>	<b>10 bp</b>	<b>24 bp</b>
<b>3. Under</b>	<b>10 bp</b>	<b>24 bp</b>	<b>27 bp</b>

## The Assessment Base Distribution and Matrix Migration

Table 5 summarizes the distribution of institutions across the assessment matrix.

**Table 5**  
**BIF Assessment Base Distribution (1)**  
**Deposits as of December 31, 2000**  
**Supervisory Subgroup and Capital Groups in Effect January 1, 2001**

Capital Group		A		B		C	
<b>1. Well</b>	Number	7,965	92.7%	383	4.5%	55	0.6%
	Base (\$billion)	3,230.1	97.1%	58.7	1.8%	6.5	0.2%
<b>2. Adequate</b>	Number	151	1.8%	15	0.2%	7	0.1%
	Base (\$billion)	27.0	0.8%	3.0	0.1%	1.0	0.0%
<b>3. Under</b>	Number	3	0.0%	2	0.0%	4	0.0%
	Base (\$billion)	0.1	0.0%	0	0.0%	0.0	0.0%

Estimated annual assessment revenue

\$ 43 million

Assessment Base

\$3,326.7 billion

Average annual assessment rate (bp)

0.13 basis points

*Notes:*

- (1) "Number" reflects the number of BIF members, including BIF-Oakar institutions; "Base" reflects all BIF-assessable deposits.

With 99 percent of the number of institutions and 99.7 percent of the assessment base in the three lowest assessment risk classifications of "1A," "1B," and "2A," as of January 1, 2001, the current distribution in the rate matrix reflects little difference from the previous period (as of July 1, 2000). The slightly lower number of institutions in these three categories (down 152) reflects continuation of industry consolidation trends, as the overall total declined by 161 institutions. There are 86 institutions outside of the "1A," "1B," and "2A" classifications, a slight decrease from 95 during the previous period.

Only 620 institutions are classified outside of the lowest assessment risk classification, up from 613 in the previous period. Of the 613 institutions that were previously classified outside of the "1A" risk classification, 145 institutions migrated into the "1A" risk classification in the current distribution (Table 6). Of the 8,139 institutions that were classified "1A" in the previous assessment period, 189 institutions migrated out of the "1A" risk classification.

Overall, the supervisory subgroup assignment was upgraded since the previous period for 99 institutions with an assessment base of \$27.0 billion and was downgraded for 126 institutions with an assessment base of \$23.4 billion.

**Table 6**  
**BIF Migration To and From Assessment Risk Classification "1A" (1)**

Institutions entering "1A"	Number	Base (\$billion)
Due to capital group reclassification only	67	11.0
Due to supervisory subgroup reclassification only	78	25.8
Due to both	0	0
Total	145	36.8
Institutions leaving "1A"	Number	Base (\$billion)
Due to capital group reclassification only	85	16.6
Due to supervisory subgroup reclassification only	98	21.2
Due to both	6	0.5
Total	189	38.3

*Notes:*

- (1) Reflects BIF-insured institutions that moved in and out of assessment risk classification "1A" from the second semiannual assessment period of 2000 to the first semiannual assessment period of 2001. The numbers only include institutions that were rated in both periods.

### **Other Issues**

**Refunds for second semiannual period of 2001.** According to the Deposit Insurance Funds Act of 1996 (Funds Act), if the reserve ratio at the end of an assessment period exceeds the DRR, the Board is required to refund such excess amount, to certain insured depository institutions. However, this refund may not exceed the amount paid in that assessment period, and refunds may not be made to institutions that exhibit certain weaknesses (financial, operational, or compliance) or are not well-capitalized. The FDIC interprets the Funds Act as requiring refunds only to those institutions classified as "1A" for purposes of the FDIC's risk-related premium system. Since BIF-insured institutions classified as "1A" currently pay no assessments to the BIF under the proposed rate schedule they are ineligible to receive any refund for the second semiannual period of 2001.

**FICO Assessment.** The Funds Act separates the Financing Corporation (FICO) assessment from the FDIC assessment, so that the amount assessed on individual institutions by the FICO is in addition to the amount paid according to the BIF rate schedule. All institutions are assessed the same rate by FICO, as provided for in the Funds Act. The FICO rate for the second annual assessment period of 2001 (subject to quarterly adjustment) will be determined using March 31, 2001, Call Report and Thrift Financial Report data in June 2001.

**Staff Contacts**

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